IDAHO OUTLOOK

NEWS OF IDAHO'S ECONOMY AND BUDGET

STATE OF IDAHO | DIVISION OF FINANCIAL MANAGEMENT | FEBRUARY 2008 VOLUME XXX NO. 8

This month the Division of Financial Management (DFM) has responded to increasing concerns about Idaho's economic and revenue outlooks by producing updated forecasts for both. These forecasts replace those used in producing the FY 2009 *Executive Budget*. The economic and revenue forecasts being replaced were produced in early December 2007 (based on Global Insight's December 2007 U.S. macroeconomic forecast), and were originally presented in the January 2008 *Idaho Economic Forecast* (IEF), the FY 2009 *General Fund Revenue Book*, and the FY 2009 *Executive Budget*. The replacement forecasts were produced in February 2008, and are based on the February 2008 U.S. macroeconomic forecast produced by Global Insight.

Updating Idaho's economic and revenue forecasts between regularly scheduled release dates is highly unusual. It is a reflection of the heightened anxiety about the direction of the U.S. economy and of a fairly dramatic change in the baseline forecast of the U.S. economy produced by Global Insight. It is also necessary to provide Idaho policy makers (the Governor and the Legislature) with timely information concerning the impact of a possible U.S. recession on Idaho's General Fund revenue stream.

Table One: U.S. Real GDP Growth Rate							
	07:Q3	07:Q4	08:Q1	08:Q2	08:Q3	08:Q4	09:Q1
Feb-08	4.9%	0.6%	-0.4%	-0.5%	3.4%	2.7%	0.7%
Jan-08	4.9%	0.0%	0.8%	1.8%	2.5%	2.9%	3.2%

Table Two: U.S. Real GDP Growth Rate					
	2007	2008	2009	2010	2011
Feb-08	2.2%	1.4%	2.2%	3.0%	3.2%
Jan-08	2.2%	1.9%	2.9%	2.9%	2.9%

Table Three: Personal Income Percent Change, February 2008 IEF					
	2007	2008	2009	2010	2011
Idaho	7.6%	4.8%	5.6%	6.1%	6.8%
U.S.	6.2%	4.1%	4.4%	5.1%	5.6%

Table Four: Personal Income Percent Change, January 2008 IEF					
	2007	2008	2009	2010	2011
Idaho	7.7%	5.7%	5.8%	6.2%	6.6%
U.S.	6.2%	4.6%	4.9%	5.2%	5.2%

On February 6th Global Insight released its regularly scheduled short-term forecast of the U.S. economy. It contained significant changes to the outlook for the U.S. economy. The previous forecast contained slow, but continuing, U.S. economic growth in 2008. Global Insight is now forecasting a recession in the first half of 2008, with a recovery beginning in the second half of 2008. The quarterly and annual impact of this forecast update on U.S. real GDP growth is shown in tables one and two.

These changes in the forecast of U.S. real GDP growth are due to more significant impacts related to the housing correction and the credit crunch. Tables three and four show the impact of this forecast revision on Idaho and U.S. personal income growth.

Essentially, Idaho is now forecasted to lose about one percentage point of personal income growth in 2008 (a reduction of $423 million), followed by reductions of 0.2 percentage point in 2009 and 0.1 in 2010. The peak of the forecasted Idaho personal income reduction (relative to the January 2008 IEF) is a decrease of $605 million in 2010, after which the gap begins to close.

These changes in the economic outlook have impacts on the outlook for Idaho's General Fund revenue. The overall General Fund revenue growth rate has been lowered by 1.7 percentage points in FY 2008 (from 3.5% to 1.8%) and by 0.6 percentage point in FY 2009 (from 3.4% to 2.8%). In dollars, the reduction in overall General Fund revenue is $50.2 million in FY 2008 and $70.1 million in FY 2009, for a combined FY2008-FY2009 revenue reduction of $120.3 million.

Both the FY 2008 and the FY 2009 revenue forecasts have been divided into their ongoing and one-time components. This is the second year that DFM has provided this distinction in its basic revenue forecasts. The ongoing components of the revenue forecast are based on the statistical relationship between the revenue stream and broad measures of the state's economy (primarily personal income). The one-time components of the revenue forecast are based on an assessment of the impacts of transitory phenomena on the revenue stream. Examples include investment booms/busts that give rise to large increases/decreases in income taxable capital gains and real estate booms/busts that give rise to unusually high/low amounts of income taxable capital gains and sales taxable building materials.

Several important characteristics are associated with ongoing and one-time components of the revenue stream. First and foremost, the ongoing component has much greater stability than the one-time component. In this regard, it is helpful to think of the ongoing portion of the revenue forecast as a trend line. The relationship between the revenue stream and broad indicators of the economy may vary from year to year, but over a longer period of time the relationship tends to be fairly stable, much like a trend line. This part of the revenue forecast is estimated using statistical methods.

A second important characteristic flows from the one-time component of the revenue stream. The year-to-year fluctuations around the ongoing, or statistically derived, portions of the revenue stream can be thought of as noise, or random variations. These variations are the part of the historical revenue stream that cannot be explained by the statistical relationship between the broad measures of the economy and the revenue stream. They are what we are identifying as the one-time component of the revenue stream. In a statistically estimated relationship these variations average zero over the historical estimation period.

Now here is the important point concerning one-time revenue: in a typical forecast period there is no reason to think that the variance will be anything other than zero. Hence there will be no expected one-time revenue. But in an ***atypical*** forecast period there may well be some ***a priori*** reason to believe there will be a variance, thereby giving rise to an expectation of one-time revenue. And here is the real kicker: the expected variance (i.e., the one-time revenue) can be either positive or negative!

A good example of this can be found in the recent stock-market bubble that built up over the decade of the 1990s and burst in 2000. As the bubble inflated, capital gains soared to unsustainably high levels and simultaneously inflated Idaho income tax (capital gains are not part of personal income, but are part of the individual income tax base). This gave rise to what in retrospect was a significant amount of one-time revenue in the late 1990s and early part of this decade.

When the stock market bubble burst in 2000, the opposite happened. Capital gains plummeted to unusually low levels and individual income tax receipts nose-dived (after adjusting for a simultaneous income tax rate reduction, normalized individual income tax receipts dropped almost 15% in FY 2002). In just one year Idaho's one-time revenue had swung from positive to negative territory.

Today we are faced with the aftermath of a similar problem: the decline in real estate values. Before continuing, it is important to emphasize that there are strong indications that Idaho's experience with the real estate bubble was not as severely inflated as that of the nation as a whole. Idaho's real estate prices inflated both later and to a lesser degree than U.S. real estate prices.

Having said that, Idaho nonetheless has experienced recent General Fund revenue levels that appear to be unsustainably high. The sources of this one-time revenue are the individual income tax and the sales tax. In FY 2006 Idaho's individual income tax produced $103 million (9.2%) more than expected based on the estimated statistical relationship between income tax receipts and the economy. In FY 2007 that amount reached $198 million, or 16.4% more than expected. A somewhat different perspective on this issue is displayed by noting that Idaho personal income actually grew by 7.4% in FY 2006, expected individual income tax growth was 6.7%, but actual individual income tax growth was 17.5%. In FY 2007 Idaho personal income actually grew by 8% and the individual income tax was expected to also grow by 8% over the level of FY 2006. Actual individual income tax growth in FY 2007 was 15.1%. These unsustainably high individual income tax growth rates are what gave rise to estimated one-time revenue of $103 million in FY 2006 and $198 million in FY 2007.

The conditions that gave rise to these extraordinary revenue increases are now unwinding, but the individual income tax has some fairly significant lags associated with it. DFM now estimates that there will be a considerable reduction in real estate boom related income tax revenue in both FY 2008 and FY 2009. The amounts estimated are $100 million in FY 2008 and $25 million in FY 2009, or year-over-year reductions of 49% and 75%, respectively.

The sales tax also had positive variances in FY 2006 and FY 2007, but the FY 2006 level was only $7.6 million, or 0.7%. This is not distinguishable from typical year-to-year noise. FY 2007, however, was $35.2 million (3.1%) higher than expected, and this is clear evidence of real estate boom related one-time revenue. Because the sales tax has much shorter lags (essentially one month) in its response to economic activity, the sales tax revenue forecast has negative one-time revenue in both FY 2008 ($26.4 million, or 2.2%) and FY 2009 ($13.2 million, or 1.1%).

The net effect of the positive individual income tax one-time revenue and the negative sales tax one-time revenue is a current estimate of positive $73.6 million in FY 2008 and positive $11.8 million in FY 2009. These one-time revenues are significantly lower than the estimated amounts of $106.8 million and $55.6 million, respectively, in the January 2008 forecast. These amounts, along with a comparison of the ongoing components, are presented in table five on the following page.

The full detail behind these changes to the economic and revenue forecasts are provided in Adobe Acrobat documents posted on DFM's web page at http://dfm.idaho.gov. These include detailed annual and quarterly economic forecast tables as presented in the regularly scheduled *Idaho Economic Forecast* and relevant tables from the *General Fund Revenue Book*.

The changed General Fund revenue forecast has also yielded a change in the amount of General Fund revenue expected on a month-by-month basis. The preliminary January revenue results were reported in early February and were based on the old General Fund revenue forecast. Under that old forecast the month was down by $36.6 million and the fiscal year-to-date shortfall was $33.1 million. With the revised General Fund revenue forecast and an update to the monthly monitoring predicted values, the actual January revenues are $21.1 million below the new predicted values and the fiscal year-to-date shortfall is $5.8 million.

Table Five: Idaho General Fund Revenue Forecast Revision, February 2008 vs January 2008[1]

February 2008 General Fund Revenue Forecast

	FY2007	FY2008	FY2009
Total	$2,812.5	$2,862.0	$2,941.8
One-Time	$224.8	$73.6	$11.8
Ongoing[2]	$2,587.7	$2,788.4	$2,930.0

Feb 2008 Percent Change

	FY2008	FY2009
Total	1.8%	2.8%
One-Time	-67.3%	-84.0%
Ongoing[2]	7.8%	5.1%

January 2008 General Fund Revenue Forecast[1]

	FY2007	FY2008	FY2009
Total	$2,812.5	$2,912.2	$3,011.9
One-Time	$231.0	$106.8	$55.6
Ongoing[2]	$2,581.5	$2,805.4	$2,956.3

Jan 2008 Percent Change

	FY2008	FY2009
Total	3.5%	3.4%
One-Time	-53.8%	-47.9%
Ongoing[2]	8.7%	5.4%

February minus January Level

	FY2007	FY2008	FY2009
Total	$0.0	($50.2)	($70.1)
One-Time	($6.2)	($33.2)	($43.8)
Ongoing	$6.2	($17.0)	($26.3)

[1] The January 2008 General Fund revenue forecast was actually prepared in early December 2007.
[2] The FY 2007 revenue number is not normalized, i.e. it only includes eight months of the extra penny of sales tax. This amounts to an estimated $80.2 million that is ***not included*** in the FY 2007 total and ongoing numbers.

FY 2009 Net Change in General Fund Availability

FY 2009 Total:	($120.3)
FY 2009 One-Time:	($94.0)
FY 2009 Ongoing:	($26.3)

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General Fund Update

As of January 31, 2008

	$ Millions		
Revenue Source	FY 2008 Executive Estimate[3]	DFM Predicted to Date	Actual Accrued to Date
Individual Income Tax	1,378.9	782.9	770.7
Corporate Income Tax	169.4	85.4	84.4
Sales Tax	1,166.0	713.8	714.3
Product Taxes[1]	26.8	16.6	16.5
Miscellaneous	120.9	55.7	62.7
TOTAL GENERAL FUND[2]	**2,862.0**	**1,654.4**	**1,648.6**

1 Product Taxes include beer, wine, liquor, tobacco and cigarette taxes
2 May not total due to rounding
3 Revised Estimate as of February 2008

The FY 2008 General Fund revenue forecast has been revised in February as a result of fairly dramatic changes in the U.S. economic outlook. The revenue numbers reported in this *Idaho Outlook* reflect revisions to both the total FY 2008 revenue forecast and the monthly predicted values. The total FY 2008 forecast has been reduced by $50.2 million. The predicted values have been updated to reflect time trends that are evident in the historical collection patterns.

Under this revised revenue forecast, the month of December was ahead of expectations by $15.5 million. Revenues in January were $21.3 million lower than expected, bringing the fiscal year-to-date shortfall to $5.8 million below the cumulative predicted amount for the end of January.

Individual income tax revenue was $18.3 million lower than expected in January. Filing collections were $5.4 million below expectations, withholding collections were $6.3 million lower than expected, and refunds were $6.5 million higher than expected. On a fiscal year-to-date basis the individual income tax is $12.2 million lower than expected, due primarily to refunds that are $11.4 million higher than expected. On the receipts side, filing collections that are $4.6 million lower than expected as of the end of January are largely offset by withholding collections that are $4.1 million higher than expected.

Corporate income tax revenue was $3.4 million lower than expected in January, and is now $1.0 million below the predicted amount for the end of January. Receipts were $2.8 million lower than expected in January ($2.2 million from filing payments and $0.5 million from estimated payments), and refunds were $0.7 million higher than expected.

Sales tax revenue was $0.4 million lower than expected in January, after being $0.8 million higher than expected in December ***under the new forecast and monthly predicted amounts***. Last month's outlook had December actual sales tax revenue $0.4 million lower than the predicted amount. The revision to the December predicted amount of sales tax revenue is primarily due to the reduction in the sales tax forecast (down $4.8 million for the fiscal year). January's receipts were initially reported to be $5.9 million lower than expected for the month. This is now cut to $0.4 million due to a combination of a) the lower forecast and b) new trend-based predicted values that reflect a shift of about two-thirds percentage point of receipts from January into February.

Product taxes were slightly below target in January and are now $0.1 million lower than expected on a year-to-date basis. Miscellaneous revenues were $0.8 million higher than expected in January due primarily to a larger-than-expected amount of Department of Environmental Quality fines. For the fiscal year to date, miscellaneous revenues are ahead by $7.0 million, with the single largest source of this being $4.7 million in excess unclaimed property receipts ($4.5 million of this came in December).